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TESTIMONY OF HELMUT A. MERKLEIN
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
AND ENERGY EMERGENCIES
DEPARTMENT OF ENERGY
BEFORE
THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
JANUARY 27, 1984

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MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE.

I WELCOME THIS OPPORTUNITY TO PRESENT THE DEPARTMENT OF ENERGY'S VIEWS ON THE WORLD OIL SITUATION AND OUTLOOK. (U)

THESE HEARINGS COME AT AN INTERESTING JUNCTURE IN THE OIL MARKET. ON THE ONE HAND, IN SPITE OF A LEVELING OFF OF THE DECLINE IN WORLD OIL DEMAND AND THE POSSIBILITY THAT 1984 WILL PRODUCE THE FIRST YEARLY INCREASE IN WORLD OIL CONSUMPTION SINCE 1979, THE FUNDAMENTAL UNDERLYING SOFTNESS OF THE OIL MARKET IS EXPECTED TO CONTINUE FOR A NUMBER OF YEARS TO COME, ABSENT A SIGNIFICANT DISRUPTION OF WORLD OIL SUPPLIES. THE POSSIBILITY OF A CUT IN NOMINAL OIL PRICES IS LIKELY TO GROW AS WE APPROACH THE SECOND HALF OF THE FIRST QUARTER OF 1984, WHEN THE DEMAND FOR OPEC OIL COULD DROP SUBSTANTIALLY ONCE AGAIN. THIS SEASONAL DROP IN DEMAND COUPLED WITH THE GROWING FINANCIAL REQUIREMENTS OF A NUMBER OF PRODUCING COUNTRIES, THE UNCERTAINTIES SURROUNDING THE RECENT MILITARY TAKE-OVER IN NIGERIA, AND THE CONTINUED INCREASE IN NON-OPEC OIL PRODUCTION MAY CREATE A CLIMATE THAT WILL MAKE IT DIFFICULT FOR THE OPEC MEMBERS TO MAINTAIN THE PRODUCTION DISCIPLINE NECESSARY TO PREVENT FURTHER CUTS IN OIL PRICES. (U)

ON THE OTHER HAND, IN SPITE OF THE EXISTENCE OF A LARGE MARGIN OF SPARE OIL PRODUCTION CAPACITY, THERE ARE SOME THINGS GOING ON IN THE WORLD THAT COULD OVERTURN THE FUNDAMENTAL UNDERLYING WEAKNESS IN THE MARKET THAT I HAVE JUST DESCRIBED; THE CONTINUING INSTABILITY IN THE MIDDLE EAST AND POSSIBLE ESCALATION OF THE IRAN-IRAQ WAR BEING CHIEF AMONG THEM. (U)

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I WOULD LIKE TO BRIEFLY REVIEW OUR PROJECTIONS AND ANALYSIS OF THE OUTLOOK FOR WORLD OIL SUPPLY AND DEMAND THROUGH 1984 WHICH IS DETAILED IN THE TABLES ACCOMPANYING MY STATEMENT. I WANT TO EMPHASIZE THAT ANY PROJECTION OF WORLD OIL SUPPLY, DEMAND, AND PRICE IS FRAUGHT WITH UNCERTAINTY, AND OUR PROJECTIONS ARE JUST AS TENUOUS. WHAT WE OFFER IS AN ANALYSIS OF THE VARIABLES RELEVANT TO THE NEAR-TERM OUTLOOK. WE ARE NOT ATTEMPTING TO FORECAST THE OUTCOME OF EVENTS, OR TO CONVINCE YOU THAT OUR CRYSTAL BALL IS ANY LESS CLOUDED THAN ANYONE ELSE'S. (U)

CONSUMPTION

THE SLIDE IN FREE WORLD OIL CONSUMPTION WHICH BEGAN IN THE AFTERMATH OF THE IRANIAN REVOLUTION CONTINUED THROUGHOUT 1983. THE ONGOING EFFECTS OF WEAK ECONOMIC GROWTH OUTSIDE THE UNITED STATES, PRICE-INDUCED CONSERVATION AND SUBSTITUTION, AND Milder than normal temperatures throughout most of the year resulted in a 1983 decline in free world oil consumption of 1.0 million barrels per day (MMBD), or about 2 percent. This decline followed declines of 1.7 MMBD and 2.1 MMBD in 1982 and 1981, respectively, bringing the total drop in free world oil consumption to 7.7 MMBD from the peak consumption level of 52.4 MMBD reached in 1979. The decline in oil consumption in the OECD (Organization for Economic Cooperation and Development) region last year accounted for virtually all of the world decline and brought OECD oil consumption to its lowest level in 13 years. (U)

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ONE NOTEWORTHY EVENT IS THE FACT THAT OECD OIL CONSUMPTION CONTINUED TO DECLINE LAST YEAR EVEN THOUGH ITS REAL GNP GREW BY MORE THAN 2.0 PERCENT. THIS FACT ATTESTS TO THE CONTINUING STRENGTH OF EFFICIENCY GAINS AND FUEL-SWITCHING IN THE VARIOUS OECD COUNTRIES, I.E., TO THE INDUSTRIALIZED NATIONS' SIZEABLE LONG-TERM PRICE ELASTICITY OF DEMAND. IT ALSO IS A CLEAR INDICATION THAT THE PRESENT PRICE OF \$29 PER BARREL IS SUFFICIENT MARKET INCENTIVE TO MAINTAIN THE INDUSTRIALIZED NATIONS' DEMONSTRATED RESOLVE TO CONTINUE TO REDUCE THEIR DEPENDENCE ON OIL IN THEIR OVERALL ENERGY MIX. TO GIVE JUST ONE EXAMPLE, THE NUCLEAR GENERATING CAPACITY IN THE OECD COUNTRIES OUTSIDE THE UNITED STATES HAS RISEN FROM 54,000 MW IN 1979 TO 85,000 MW IN 1983, SQUEEZING THE EQUIVALENT OF 300 MILLION BARRELS PER YEAR OUT OF OIL IMPORTS AND OTHER FUELS. OF THE 24 OECD NATIONS FINLAND, FRANCE AND BELGIUM HAVE REACHED OR EXCEEDED 40 PERCENT OF THEIR ELECTRICITY GENERATION THROUGH NUCLEAR PLANTS, COMPARED TO 13 PERCENT IN THE UNITED STATES.(U)

THE OUTLOOK FOR WORLD OIL CONSUMPTION IN 1984 REMAINS DEPENDENT ON THE TIMING AND PACE OF THE ECONOMIC RECOVERY, OIL PRICE DEVELOPMENTS, THE STRENGTH OF EFFICIENCY GAINS AND FUEL-SWITCHING, THE RELATIVE STRENGTH OF THE DOLLAR AGAINST OTHER CURRENCIES, THE WEATHER, AND MANY OTHER FACTORS.(U)

A PROJECTED STRENGTHENING OF ECONOMIC RECOVERY IN 1984 (+3.5 PERCENT REAL GNP GROWTH IN THE OECD REGION) MAY CAUSE

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OECD PRIMARY ENERGY CONSUMPTION TO RISE BY 1.5-2.0 MMBD OIL EQUIVALENT. DURING THIS PERIOD, NON-OIL ENERGY USE IS PROJECTED TO INCREASE BY ABOUT 1.0 MILLION BARRELS PER DAY OIL EQUIVALENT (MMBD), RESULTING IN A SLIGHT INCREASE OF OECD OIL CONSUMPTION OF ABOUT 0.5 TO 1.0 MMBD, DEPENDING ON THE FACTORS PREVIOUSLY MENTIONED.(U)

MOST OF THE PROJECTED INCREASE IN OECD OIL CONSUMPTION IS EXPECTED TO BE CONCENTRATED IN THE UNITED STATES, WHICH IS LEADING THE REST OF THE WORLD IN THE PRESENT ECONOMIC RECOVERY. OIL CONSUMPTION IN EUROPE AND JAPAN IS EXPECTED TO BE LARGELY UNCHANGED FROM 1983.(U)

THE RISING FOREIGN EXCHANGE VALUE OF THE DOLLAR HAS BEEN AN IMPORTANT FACTOR RETARDING OIL CONSUMPTION IN MANY COUNTRIES DURING THE PAST YEAR. IN FRANCE, GERMANY, AND ITALY, CURRENCY EFFECTS ALONE HAVE RAISED THE LOCAL CURRENCY COSTS OF OPEC CRUDE OIL FROM \$29 PER BARREL IN MARCH OF LAST YEAR TO THE EQUIVALENT OF \$32.70 PER BARREL IN FRANCE AND ITALY, AND TO ABOUT \$32.15 PER BARREL IN GERMANY BY THE END OF 1983, OFFSETTING MUCH OF THE PRICE CUT BY OPEC LAST SPRING. INFLATION HAS MODERATED THIS TREND SOMEWHAT, BUT REAL PRICES IN LOCAL CURRENCY TERMS ARE NOW HIGHER IN MANY COUNTRIES THAN THEY WERE LAST SPRING IMMEDIATELY AFTER THE OPEC PRICE REDUCTION.(U)

IN SUMMARY, WITH THE ONSET OF STRONGER ECONOMIC GROWTH AND GRADUAL DILUTION OF THE EFFECTS OF PAST PRICE INCREASES, THE PATTERN OF YEARLY OIL CONSUMPTION DECLINES MAY REVERSE ITSELF

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IN 1984. FREE WORLD OIL CONSUMPTION COULD INCREASE BY 1 TO 2 PERCENT THIS YEAR UNDER THESE CIRCUMSTANCES, OR POSSIBLY MORE IF THERE IS A STRONG RECOVERY IN INDUSTRIAL OUTPUT OR A WEAKENING OF THE DOLLAR VIS-A-VIS OTHER CURRENCIES.(U)

OIL PRODUCTION

NON-OPEC OIL SUPPLIES ROSE AT AN AVERAGE ANNUAL RATE OF NEARLY 1 MMBD PER YEAR IN THE SIX YEARS FROM 1977 TO 1983, AND THEY ARE EXPECTED TO RISE BY AN ADDITIONAL 0.4 TO 0.9 MMBD IN 1984. MOST OF THE PAST INCREASES OCCURRED IN THE NORTH SEA AND MEXICO, BUT THERE WERE ALSO SIGNIFICANT GAINS IN EGYPT AND OTHER DEVELOPING COUNTRIES. THE MAINTENANCE OF HIGH LEVELS OF OIL PRODUCTION IN THE UNITED STATES, AGAINST EARLIER EXPECTATIONS OF A GRADUAL DECLINE, HAS ALSO CONTRIBUTED TO THE OVERALL STRENGTH OF NON-OPEC SUPPLIES.(U)

THE COMBINED EFFECTS OF DECLINING OIL CONSUMPTION, NON-OPEC PRODUCTION GAINS, AND LIQUIDATION OF INVENTORIES HAVE BEEN DRAMATIC:(U)

- OPEC CRUDE OIL PRODUCTION FELL IN 1983 TO AN ESTIMATED 17.6 MMBD, THE LOWEST LEVEL SINCE 1967, AND NEARLY 13 MMBD BELOW THE 1977 PEAK OPEC PRODUCTION LEVEL;(U)
- OPEC'S SHARE OF FREE WORLD OIL SUPPLIES FELL TO 40 PERCENT IN 1983 FROM 62 PERCENT IN 1977; AND (U)

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- CRUDE OIL OUTPUT IN SAUDI ARABIA, OPEC'S "SWING" PRODUCER, AVERAGED ONLY 4.1 MMBD DURING THE FIRST HALF OF 1983, LESS THAN HALF THE 9.6 MMBD AVERAGE PRODUCTION LEVEL REACHED IN 1981.(U)

THE GRADUAL CESSATION OF INVENTORY LIQUIDATION AND THE SWING TOWARD INVENTORY BUILD THAT OCCURRED BETWEEN THE SECOND AND THIRD QUARTERS OF 1983, COUPLED WITH STRONGER SEASONAL CONSUMPTION ALLOWED OPEC CRUDE OIL PRODUCTION TO RECOVER FROM THE LOW OF 16.4 MMBD EXPERIENCED IN THE FIRST HALF OF 1983 TO AN ESTIMATED LEVEL OF 18.8 MMBD IN THE SECOND-HALF OF THE YEAR, NOTWITHSTANDING THE MARCH 1983 OPEC ACCORDS WHICH PLACED A 17.5 MMBD CEILING ON OPEC CRUDE OIL PRODUCTION. INVENTORY DRAWDOWN IN ANTICIPATION OF THE MARCH 1983 CONTRIBUTED TO THE DEPRESSED LEVEL OF PRODUCTION IN THE FIRST HALF OF 1983.(U)

THE PRODUCTION INCREASE IN THE SECOND HALF OF 1983 PULLED OPEC'S AVERAGE 1983 CRUDE OIL OUTPUT UP TO AN ESTIMATED LEVEL OF 17.6 MMBD (18.4 MMBD INCLUDING NATURAL GAS LIQUIDS OR NGL), DOWN FROM THE 1982 CRUDE OUTPUT AVERAGE OF 18.8 MMBD (19.7 MMBD INCLUDING NGL). WHILE ALMOST EVERY OPEC PRODUCER EXCEEDED ITS INDIVIDUAL QUOTA AT SOME POINT LAST YEAR, ON AVERAGE, DURING THE LAST 9 MONTHS OF 1983, MOST OPEC COUNTRIES STAYED WITHIN THEIR INDIVIDUAL QUOTAS. THE FEW COUNTRIES THAT EXCEEDED THEIR QUOTAS DURING THIS PERIOD, DID SO BY LESS THAN 100,000 BARRELS PER DAY.(C)

SAUDI ARABIA, OPEC'S "SWING" PRODUCER AND ONLY COUNTRY WITHOUT AN INDIVIDUAL QUOTA PER SE, WAS RESPONSIBLE FOR THE BULK OF THE GROUP'S OUTPUT IN EXCESS OF 17.5 MMBD DURING THE

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LATTER PART OF 1983. SAUDI ARABIA'S BEHAVIOR MAY BE CONDITIONED BY THEIR INTENT OR DESIRE TO "SWING" BOTH WAYS, I.E., ^{TO} TO COUNTERBALANCE THE LOW PRODUCTION RATES THEY WILL HAVE ^{TO} TO ACCEPT DURING PERIODS OF WEAK DEMAND WITH HIGHER PRODUCTION RATES WHENEVER THE MARKET IMPROVES.(C)

BEFORE WE LEAVE THE SUBJECT OF SAUDI ARABIA'S PRODUCTION AND EXPORTS, TWO OTHER DEVELOPMENTS SHOULD ALSO BE NOTED. FIRST, SAUDI ARABIA HAS BEEN EXPORTING APPROXIMATELY 300,000 BARRELS PER DAY ON BEHALF OF IRAQ SINCE JULY OF 1983. THIS VOLUME IS INTENDED TO COVER THE DIFFERENCE BETWEEN IRAQ'S EXPORT-CONSTRAINED PRODUCTION AND THEIR 1.2 MMBD INDIVIDUAL QUOTA (WITHIN THE OPEC 17.5 MMBD CEILING). SAUDI ARABIA HAS TAKEN THE POSITION THAT THE VOLUME PRODUCED AND EXPORTED ON BEHALF OF ANOTHER OPEC MEMBER (I.E. IRAQ) SHOULD BE COUNTED AGAINST IRAQ'S CEILING IN THE CONTEXT OF THE LONDON OPEC ACCORDS. /

SECOND, SINCE LATE NOVEMBER, 1983, SAUDI ARABIA HAS CHARTERED A NUMBER OF VLCC'S (VERY LARGE CRUDE CARRIERS) TANKERS FOR THE PURPOSE OF ESTABLISHING AN ESTIMATED 45 MILLION BARRELS OF CRUDE OIL TO FLOATING STORAGE OUTSIDE THE GULF.

SHEIK YAMANI, IN PRIVATE CONVERSATIONS WITH SECRETARY HODEL, HAS ATTRIBUTED THE INCREASE IN FLOATING STORAGE TO A DESIRE TO BUILD AN EMERGENCY RESERVE AS A PRECAUTION AGAINST A POSSIBLE DISRUPTION OF CRUDE EXPORTS THROUGH THE STRAIT OF HORMUZ.

INDUSTRY INDUSTRY OBSERVERS, HOWEVER, ATTRIBUTE THE INCREASE IN FLOATING RESERVE TO COMMERCIAL CONSIDERATIONS RELATED TO

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UPCOMING OIL FIELD WORK THAT WILL AFFECT THE OUTPUT OF MEDIUM AND HEAVY CRUDES. WHATEVER THE REASON, THE INCREASE IN STORAGE HAS SUPPORTED ADDITIONAL SAUDI PRODUCTION AND EXPORTS OF NEARLY 1.0 MMBD THROUGHOUT DECEMBER AND JANUARY.(C)

WITH CONSUMPTION LAGGING ALMOST EVERYWHERE OUTSIDE THE UNITED STATES, MARKET PERCEPTIONS ARE NOW SURFACING THAT OPEC PRODUCTION MAY HAVE RISEN TOO HIGH, TOO QUICKLY, RESULTING IN UNWANTED INVENTORY ACCUMULATION DURING THE FOURTH QUARTER OF 1983. THIS HAS BEEN REFLECTED MOST RECENTLY IN A RETREAT OF MOST SPOT CRUDE PRICES, AND SOME OFFICIAL PRICES, IN SPITE OF THE TEMPORARY FIRMNESS ASSOCIATED WITH THE COLD SNAP IN NORTH AMERICA.(U)

OPEC PRODUCTION HAS REMAINED HIGH THUS FAR IN 1984. THIS, ALONG WITH THE RESULTING EXTRA INVENTORY AND COMING SEASONAL DOWNTURN IN CONSUMPTION, COULD ONCE AGAIN BECOME AN IMPORTANT FACTOR CONTRIBUTING TO WEAKNESS IN OIL PRICES AND DOWNWARD PRESSURE ON OPEC PRODUCTION IN THE NEXT FEW MONTHS. THE CURRENT SITUATION IN THE OIL MARKET IS SOMEWHAT SIMILAR TO THE SITUATION LAST YEAR AT THIS TIME, WITH SEVERAL IMPORTANT DIFFERENCES, NOTABLY:(U)

- EXPECTATIONS OF AN OIL PRICE DECLINE DO NOT APPEAR TO BE AS WIDESPREAD THIS YEAR;(U)
- THE DIFFERENCE BETWEEN SPOT AND OFFICIAL SALES PRICES, CURRENTLY LESS THAN \$1.00 PER BARREL, IS NOWHERE NEAR THE \$5-\$6 PER BARREL DIFFERENCE PREVAILING LAST YEAR;(U)

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- COMMERCIAL INVENTORIES ARE LOWER THIS YEAR, MAKING IT LESS LIKELY THAT THE INDUSTRY COULD SUSTAIN THE MASSIVE DRAWDOWN AND DROP IN CRUDE LIFTINGS THAT OCCURRED LAST YEAR; AND(U)
- MEXICO HAS ADOPTED A POLICY OF SUPPORT FOR THE OPEC ACCORDS BY LIMITING ITS EXPORTS TO 1.5 MMBD.(U)

NEVERTHELESS, IN ORDER TO PREVENT EXTREME DOWNWARD PRESSURE ON OIL PRICES, IT IS OUR PRESENT VIEW THAT OPEC CRUDE OIL PRODUCTION MIGHT HAVE TO DECLINE TO APPROXIMATELY 17.0 MMBD DURING THE SECOND QUARTER OF 1984, WITH A STRONG POSSIBILITY THAT PRODUCTION WOULD HAVE TO BE EVEN LOWER FOR A SHORT PERIOD OF TIME. GIVEN THESE CIRCUMSTANCES AND THE DETERIORATING FINANCIAL POSITION OF A NUMBER OF OPEC PRODUCERS, SAUDI ARABIA MAY BE FORCED TO BEAR THE VOLUMETRIC BRUNT OF LOWER PRODUCTION IF IT WISHES TO AVOID A PRICE DECLINE, EVEN IF THE OTHER OPEC MEMBERS ADHERE TO THEIR PRODUCTION CEILINGS. PRODUCTION IN EXCESS OF THE AGREED QUOTAS BY ONE OR SEVERAL OPEC PRODUCERS WOULD PLACE AN EVEN GREATER BURDEN ON SAUDI ARABIA IN ITS ROLE AS SWING PRODUCER AND INCREASE THE POSSIBILITY OF A DECLINE IN PRICES.(U)

WE BELIEVE THE SAUDIS WILL TAKE NECESSARY PRODUCTION CUTS TO MAINTAIN THE \$29 PER BARREL PRICE. THEIR COMMITMENT TO THAT PRICE MAINTENANCE WAS REITERATED TO SECRETARY HOEL BY SHEIK YAMANI DURING THE SECRETARY'S RECENT VISIT TO THE MIDDLE EAST. AT THE SAME TIME, WE DO NOT BELIEVE THE SAUDIS WOULD BE RECEPTIVE TO PLEAS FOR A GREATER MARKET SHARE BY ANY OTHER OPEC PRODUCER.(C)

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WHILE WE EXPECT OPEC PRODUCTION TO BE SLIGHTLY HIGHER ON AVERAGE FOR 1984 AS A WHOLE, OPEC PRODUCTION IS LIKELY TO REMAIN FAR BELOW THEIR DESIRED LEVELS AND SUBJECT TO SUBSTANTIAL FLUCTUATIONS WITH SEASONAL CHANGES IN CONSUMPTION AND INDUSTRY PERCEPTIONS OF INVENTORY REQUIREMENTS. THE STRAINS OF MAINTAINING PRODUCTION DISCIPLINE AMONG OPEC MEMBERS ARE LIKELY TO CONTINUE THROUGHOUT THIS YEAR; THEY WILL BE ESPECIALLY PRONOUNCED IN THE MONTHS IMMEDIATELY AHEAD.(U)

ONE NOTEWORTHY CASE WORTH MENTIONING IS THE JANUARY 1, 1984, MILITARY TAKE-OVER IN NIGERIA LED BY MAJOR GENERAL MUHAMMADU BUHARI, WHO SERVED AS MINISTER OF PETROLEUM AND CHAIRMAN OF THE NIGERIAN NATIONAL PETROLEUM COMPANY (NNPC) IN THE MILITARY GOVERNMENT WHICH RULED NIGERIA JUST PRIOR TO THE NOW DEPOSED CONSTITUTIONAL GOVERNMENT.(U)

BUHARI HAS CITED SEVERE ECONOMIC PROBLEMS AS ONE OF THE MAIN REASONS FOR THE TAKE-OVER. AT THE SAME TIME, HE HAS REAFFIRMED HIS COUNTRY'S COMMITMENT TO BOTH THE INTERNATIONAL OIL AND FINANCIAL COMMUNITIES THAT CURRENT OBLIGATIONS BE MET; BUHARI HAS ALSO STATED HIS INTENTION TO KEEP NIGERIA IN OPEC.(U)

NIGERIA FACES ITS MOST SEVERE ECONOMIC RECESSION SINCE THE 1967-70 CIVIL WAR. ECONOMIC OUTPUT IN 1983 WAS ROUGHLY 20 PERCENT BELOW THAT OF 1981. OIL REVENUES WHICH ACCOUNT FOR AS MUCH AS 95 PERCENT OF FOREIGN EXCHANGE RECEIPTS AND 80 PERCENT OF GOVERNMENT REVENUES REACHED ONLY \$11 BILLION IN 1983, LESS THAN HALF OF A PEAK OF \$22-24 BILLION IN 1980.(C)

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GIVEN SUCH REVENUE NEEDS, SPECULATION ABOUNDS THAT THE FEDERAL MILITARY GOVERNMENT (FMG) WILL ATTEMPT TO RAISE OIL PRODUCTION OR LOWER PRICES OR BOTH IN ORDER TO INCREASE OIL REVENUES. DESPITE THE CURRENT MARKET OUTLOOK, WE ANTICIPATE BUHARI WILL TRY AGAIN TO GET AN INCREASE IN NIGERIA'S PRODUCTION QUOTA FROM OPEC. ALREADY, CLASSIFIED REPORTS HAVE COME IN CITING OFFERINGS OF BONNY LIGHT BY TRADING COMPANIES FOR AS MUCH AS \$5.00 PER BARREL DISCOUNT. THE FACT THAT NIGERIAN CRUDE WAS SOLD BY TRADING COMPANIES DURING THE LATE 1970'S WHEN BUHARI WAS HEAD OF NNPC LENDS CREDENCE TO THAT PART OF THE REPORTING. HOWEVER, WE WOULD NOT EXPECT THE FMG TO APPROVE SUCH A SUBSTANTIAL PRICE DISCOUNT, PARTICULARLY WHEN SUCH A MOVE COULD PROVOKE OTHER OPEC MEMBERS TO RETALIATE.(C)

DESPITE THE NEED FOR REVENUES, WE DO NOT EXPECT THE FMG TO ADOPT AN OIL PRODUCTION OR PRICING POLICY THAT WOULD DESTABILIZE THE CURRENT OPEC AGREEMENT. WE DO EXPECT BUHARI TO APPEAL TO OPEC TO RAISE NIGERIA'S PRODUCTION QUOTA BY PERHAPS 200,000 B/D AND/OR DECREASE THE PRICE DIFFERENTIAL FOR NIGERIAN CRUDES. SHOULD THIS APPEAL FAIL--AND WE EXPECT THAT IT WILL--AT LEAST FOR THE FIRST HALF OF THE YEAR, THE NIGERIAN GOVERNMENT MAY TRY TO "CHEAT" ON ITS QUOTA BY A SMALL AMOUNT, OR DROP ITS LONG-STANDING OBJECTIONS TO DIRECT BARTER DEALS.(C)

INVENTORIES

ANOTHER FACTOR WHICH HAS AN IMPORTANT IMPACT ON CRUDE OIL PRICES AND PRODUCTION LEVELS IS THE PATTERN OF INVENTORY

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BEHAVIOR. ALTHOUGH TOTAL FREE WORLD OIL INVENTORIES HAVE DECLINED FROM ABOUT 4,800 MILLION BARRELS AT THE BEGINNING OF 1979 TO ABOUT 4,490 MILLION BARRELS BY THE END OF 1983, FREE-WORLD OIL CONSUMPTION HAS DECLINED AS WELL. IN 1979 FREE-WORLD OIL CONSUMPTION EQUALLED ABOUT 52.4 MILLION BARRELS PER DAY WHILE CONSUMPTION IN 1983 HAS DECLINED TO ABOUT 45.0 MMBD. A USEFUL COMPARATIVE STATISTIC IS THE RELATIVE DAYS OF CONSUMPTION IMPLIED BY THESE STOCK AND CONSUMPTION LEVELS, WHICH ARE ABOUT 92 DAYS AT THE BEGINNING OF 1979 COMPARED TO ABOUT 100 DAYS AT THE END OF 1983. ALTHOUGH MINIMUM OPERATING LEVELS ARE TAKEN INTO ACCOUNT IN DAYS COVERAGE, THESE MINIMUM REQUIREMENTS MOVE WITH CHANGES IN CONSUMPTION, SO THAT DAYS COVERAGE REMAINS A USEFUL INDICATOR OF STOCK ADEQUACY.(U)

STOCK LEVELS IN THE U.S. FOR THE SAME PERIOD HAVE SHOWN AN EVEN MORE FAVORABLE TREND, AS STOCKS ACTUALLY INCREASED FROM 1,278 MILLION BARRELS AT THE BEGINNING OF 1979 TO AN ESTIMATED 1,480 MILLION BARRELS AT THE BEGINNING OF 1984. CONSUMPTION DURING THE SAME PERIOD DROPPED FROM 18.5 MMBD IN 1979 TO 15.1 MMBD IN 1983, SHOWING AN INCREASE IN STOCKS, MEASURED IN DAYS OF CONSUMPTION FROM ABOUT 70 AT THE BEGINNING OF 1979 TO ABOUT 98 IN THE BEGINNING OF 1984. THESE GROSS STOCK LEVELS INCLUDE BOTH STOCKS HELD BY COMPANIES ESSENTIAL TO THE OPERATION OF THE PETROLEUM DISTRIBUTION SYSTEM AND THE SPR, AND THEREFORE CANNOT BE USED AS A MEASURE OF TOTAL AVAILABILITY IN THE CASE OF A

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DISRUPTION. THEY DO, HOWEVER, GIVE A GOOD INDICATION OF HOW THE RELATIONSHIP BETWEEN STOCK LEVELS AND DEMAND HAS IMPROVED IN THE U.S. OVER THE PAST FIVE YEARS.(U)

INDUSTRY INVENTORY BEHAVIOR FOR 1984 IS HIGHLY UNCERTAIN. THEREFORE, THE ATTACHED PROJECTIONS ARE BASED ON THE ASSUMPTION THAT THE MARKET CONDITIONS THAT WERE THE DRIVING FORCE BEHIND COMMERCIAL INVENTORY LIQUIDATION OVER THE PAST TWO YEARS REMAIN IN PLACE TO PRODUCE A SLIGHT FURTHER DECLINE IN COMMERCIAL INVENTORIES. THE OPPOSITE, HOWEVER, COULD OCCUR. THIS DECLINE IS ASSUMED TO BE ROUGHLY OF THE SAME MAGNITUDE AS THE PROJECTED INCREASE IN GOVERNMENT STRATEGIC RESERVES.

THE U.S. PETROLEUM SITUATION

IN THE U.S. OIL MARKET WE HAVE WITNESSED A NUMBER OF IMPORTANT TRENDS:(U)

- U.S. OIL DEMAND AND OIL IMPORTS HAVE REMAINED WELL BELOW THE PEAK LEVELS REACHED IN THE LATE SEVENTIES, AND THE U.S. IS NOW MUCH LESS RELIANT ON OIL TO MEET ITS ENERGY REQUIREMENTS;(U)
- THE SOURCE OF OUR OIL IMPORTS HAS BEEN DIVERSIFIED SIGNIFICANTLY OVER THE LAST FEW YEARS, REDUCING OUR PREVIOUS PREDOMINANT RELIANCE ON OPEC OIL; AND(U)
- THE U.S. STRATEGIC OIL RESERVE HAS GROWN TO THE POINT WHERE IT NOW PROVIDES A NOT INSIGNIFICANT DEGREE OF INSURANCE AGAINST THE CONSEQUENCES OF MAJOR DISRUPTIONS.(U)

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A FEW STATISTICS WILL ILLUSTRATE THE MAGNITUDE OF THESE CHANGES. U.S. OIL DEMAND FOR THE WHOLE OF 1983 IS ESTIMATED TO HAVE BEEN 15.1 MILLION BARRELS PER DAY, DOWN SLIGHTLY FROM 15.3 MMBD THE YEAR BEFORE. THIS IS THE LOWEST ANNUAL CONSUMPTION FIGURE SINCE 1970. IT IS ESTIMATED THAT U.S. NET OIL IMPORTS IN 1983 WERE ABOUT 4.0 MILLION BARRELS PER DAY (4.2 MMBD INCLUDING IMPORTS FOR THE STRATEGIC PETROLEUM RESERVE), A VERY SLIGHT DECREASE FROM THE 1982 LEVEL; BUT LESS THAN HALF THE AMOUNT WE WERE IMPORTING IN 1977. LAST YEAR OIL IMPORTS PROVIDED AN ESTIMATED 12 PERCENT OF U.S. ENERGY CONSUMPTION, COMPARED TO 24 PERCENT IN 1977.(U)

WHILE SOME INCREASE IN U.S. OIL DEMAND AND IMPORTS CAN BE EXPECTED AS THE ECONOMIC RECOVERY PROCEEDS, SIGNIFICANT IMPROVEMENTS HAVE OCCURRED IN ENERGY EFFICIENCY WHICH WILL DAMPEN THE RESPONSE OF OIL DEMAND TO ECONOMIC GROWTH. FURTHER USE OF DOMESTICALLY PRODUCED FUELS SUCH AS NATURAL GAS COULD OCCUR, ALSO DAMPENING MARKET DEMAND. NEVERTHELESS, WE NOW EXPECT U.S. OIL CONSUMPTION TO INCREASE BY 3-5 PERCENT TO AN ESTIMATED LEVEL IN THE RANGE OF 15.5-15.9 MMBD. WITH DOMESTIC PRODUCTION LARGELY UNCHANGED, THIS RISE IN CONSUMPTION COULD PULL OUR NET OIL IMPORTS UP BY AS MUCH AS 26 PERCENT TO A LEVEL IN THE RANGE OF 4.7-5.3 MMBD (EXCLUDING IMPORTS FOR THE SPR).(U)

U.S. RELIANCE ON OPEC OIL HAS ALSO FALLEN SIGNIFICANTLY. IN THE FIRST THREE QUARTERS OF 1983, OPEC IMPORTS REPRESENTED ONLY 12 PERCENT OF U.S. OIL DEMAND. BY CONTRAST, WE DERIVED 20

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PERCENT OF OUR OIL NEEDS FROM OPEC IN 1982 AND 34 PERCENT IN 1977. MEXICO HAS NOW REPLACED SAUDI ARABIA AS THE LARGEST U.S. SUPPLIER, AND NO PERSIAN GULF OIL EXPORTER WAS AMONG OUR TOP FIVE SUPPLIERS.(U)

ANOTHER IMPORTANT MEASURE OF OUR ENERGY SECURITY IS OUR STRATEGIC PETROLEUM RESERVE, WHICH NOW CONTAINS OVER 380 MILLION BARRELS OF OIL, NEARLY 90 DAYS OF OUR ESTIMATED 1983 NET OIL IMPORTS, AND ALMOST 1000 DAYS OF OUR ESTIMATED 1983 IMPORTS FROM THE ARABIAN (PERSIAN) GULF REGION.(U)

THE STRATEGIC RESERVE IS NEARLY FOUR TIMES THE LEVEL IN PLACE WHEN THIS ADMINISTRATION TOOK OFFICE. U.S. PRIVATE OIL STOCKPILES ARE SIGNIFICANT RELATIVE TO U.S. OIL REQUIREMENTS. COMPARED TO CURRENT CONSUMPTION LEVELS, U.S. CRUDE OIL SUPPLIES ARE PLENTIFUL AND U.S. REFINERS HAVE AMPLE SPARE CAPACITY TO BOOST OUTPUT TO MEET SEASONAL CHANGES IN PRODUCT DEMAND.(U)

THREAT OF DISRUPTION

THE SUPPLY AND DEMAND PICTURE I HAVE PRESENTED ATTEMPTS TO PORTRAY AN OUTLOOK FOR THIS YEAR IN A NORMAL WORLD FREE OF UNEXPECTED DEVELOPMENTS SUCH AS A MAJOR DISRUPTION OF WORLD OIL SUPPLIES. WE ARE CLOSELY FOLLOWING DEVELOPMENTS IN THE MIDDLE EAST, AND WE ARE INITIATING AN INTERAGENCY CONSULTATION PROCESS THAT WILL ENABLE US TO RESPOND IN A COORDINATED FASHION TO ANY MAJOR DISRUPTION THAT MIGHT OCCUR.(U)

MANY DISRUPTION SCENARIOS COULD BE ENVISIONED RANGING FROM MINOR, SHORT-TERM DISRUPTIONS AT A SINGLE FACILITY TO A TOTAL

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CURTAILMENT OF OIL FLOWS FROM THE PERSIAN GULF REGION. WE AND OTHER AGENCIES ARE EXAMINING ON A COORDINATED BASIS THE RANGE OF PROJECTED ENERGY AND ECONOMIC CONSEQUENCES OF A CONSIDERABLE NUMBER OF THESE DISRUPTION SCENARIOS.(U)

OBVIOUSLY, THE ESTIMATED IMPACT OF A GIVEN DISRUPTION WILL DEPEND UPON A LARGE NUMBER OF CIRCUMSTANCES AND VARIABLES, INCLUDING THE MAGNITUDE AND DURATION OF THE DISRUPTION, OFF-SETTING PRODUCTION INCREASES FROM EXCESS WORLD PRODUCTION CAPACITY, GOVERNMENTS' AND PRIVATE INVENTORY RESPONSE TO THE DISRUPTION, AND NUMEROUS PSYCHOLOGICAL FACTORS INCLUDING THE PERCEPTIONS AND EXPECTATIONS OF MARKET PARTICIPANTS. THE USE OF OTHER FUELS, SUCH AS NATURAL GAS, COULD ALSO OFFSET TO SOME DEGREE THE EFFECTS OF AN OIL SUPPLY DISRUPTION.(U)

ALTHOUGH THE DEPARTMENT OF ENERGY HAS COMPLETED A PRELIMINARY ANALYSIS OF THESE MATTERS, WE ARE IN THE MIDST OF WORKING WITH OTHER GOVERNMENT AGENCIES TO TAKE ADVANTAGE OF THEIR RESPECTIVE DATA AND ANALYTICAL CAPABILITIES. WE ARE WORKING DILIGENTLY TO COMPLETE THIS PROCESS.(U)

CONCLUSION

THE FUNDAMENTAL UNDERLYING WEAKNESS IN THE WORLD OIL MARKET IS LIKELY TO CONTINUE THROUGHOUT 1984 AND BEYOND. THE ACTUAL OUTCOME REMAINS SOMEWHAT UNCERTAIN AND IS DEPENDENT ON A LARGE NUMBER OF FACTORS. THE DEPARTMENT OF ENERGY IS

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PAYING CLOSE ATTENTION TO A NUMBER OF FACTORS WHICH MAY HAVE PARTICULAR SIGNIFICANCE AT THIS TIME, INCLUDING:(U)

- ° THE PACE OF ECONOMIC RECOVERY;
- ° WEATHER;
- ° DEVELOPMENTS IN THE IRAN/IRAQ WAR;
- ° EXPECTATIONS OF MARKET PARTICIPANTS;
- ° NIGERIAN PRODUCTION POLICY UNDER THE NEW GOVERNMENT;
- ° INVENTORY MOVEMENTS;
- ° EXCHANGE RATES; AND
- ° PRODUCTION POLICY IN SAUDI ARABIA.

WHILE SMALL CHANGES IN ANY OF THESE ELEMENTS MAY BE SIGNIFICANT ENOUGH TO AFFECT PRICES IN THE SHORT RUN, UNDERLYING OIL DEMAND AND SUPPLY TRENDS ULTIMATELY WILL DETERMINE THE LONG TERM OUTCOME.(U)

THANK YOU VERY MUCH.

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WORLD OIL OUTLOOK
(Million Barrels Per Day)

	<u>1983</u>	<u>1984</u>
<u>Consumption</u>		
United States	15.1	15.5 - 15.9
U.S. Territories	0.3	0.3 - 0.4
Western Europe	11.9	11.5 - 12.1
Japan	4.4	4.3 - 4.4
Other OECD	2.2	2.1 - 2.3
Total OECD	<u>33.8</u>	<u>34.0 - 34.9</u>
Other Market Economies	11.2	11.1 - 11.5
Total Consumption	<u>45.0</u>	<u>45.1 - 46.4</u>
<u>Supply</u> ^{a/}		
United States	10.7	10.7 - 10.8
Canada	1.7	1.6 - 1.7
North Sea	3.1	3.2 - 3.4
Other Developed Countries	1.2	1.2 - 1.3
Mexico	3.0	3.0 - 3.2
Other Non-OPEC	4.4	4.5 - 4.6
OPEC	18.4	19.0 - 20.0
Net CPE Exports	1.8	1.5 - 1.8
Total Supply	<u>44.3</u>	<u>45.0 - 46.5</u>
Stocks Change	(0.7)	(0.2) - 0.2

- a. Includes production of crude oil and natural gas liquids, refinery gains, production of alcohol and other liquid hydrocarbons from other sources of energy, and net exports of oil from Communist countries.

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UNITED STATES OIL OUTLOOK
(Million Barrels per Day)

	<u>1983</u>	<u>1984</u>	
Consumption	15.1	15.5-15.9	-1
Production	10.7	10.7-10.8	
Net Imports:			
Excluding SPR	4.0	4.7- 5.3	
SPR Fill Rate	<u>0.2</u>	<u>0.2</u>	
Total Net Imports	4.2	4.9- 5.5	
Stock Change:			
Commercial	(0.2)	(0.1)-0.1	
SPR	<u>0.2</u>	<u>0.2</u>	
Total Stock Change	0.0	0.1- 0.3	
Unaccounted For	0.2	-	

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